

## Chapter 1: Executive Summary

### **1.a Legislative Directive:**

In the 2002 supplemental capital budget the legislature directed the Department of Natural Resources and trust beneficiaries to study options for increasing trust revenues, focusing on the comparison of returns over time from purchasing replacement trust land or investing the proceeds from land sales in the trusts' permanent funds.

The legislature further directed the department to report on the study to the legislature. This report is in response to that request.

### **1.b Background:**

Washington received 3.2 million acres of federal grant land at statehood. The two forest board trusts were added in the 1920s and 1930s. The preservation of the corpus of the trusts in some form has been an important consideration from the time the grants were created. Congress provided for the perpetuation of the educational trusts in Section 11 of the Enabling Act, by requiring that proceeds from the sale or permanent disposal of educational trusts' assets be placed into permanent funds.

Permanent funds were established for the Common School, Normal School, Scientific School, Agricultural School, and State University (University Original) trusts. These trust funds support the following educational institutions, respectively: the common schools, the state's four regional universities, Washington State University (both Scientific and Agricultural) and the University of Washington. There is no permanent fund for the Charitable, Educational, Penal, and Reformatory Institutions (CEP&RI), Capitol, or the forest board trusts. The proceeds from the sale of land, permanent rights-of-way, and non-renewable resources from the portion of the CEP&RI designated for support of the University of Washington are currently deposited in the University Permanent Fund<sup>1</sup>.

The question of whether to retain and manage trust lands, or to divest of them and invest the proceeds in the permanent funds has been an ongoing debate since statehood. The

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<sup>1</sup> See RCW 43.79.060 and RCW 28B.20.800 through RCW 28B.20.820

state has retained 2.2 million acres, 69 percent of the original grant lands. Most of the 974,000 acres disposed of were sold prior to 1930. Since 1930 the state has had a strong policy of retaining its trust land base.

The Department of Natural Resources was created in 1957. One of the duties given to the department by the legislature is to establish policies to ensure that the disposition and acquisition of trust lands is based on sound principles designed to achieve the maximum effective development and use of trust lands (**RCW 43.30.150(2)**).

The original grants were scattered and difficult to manage, which limited revenues to the beneficiaries. To remedy this problem, the legislature has given the department tools to facilitate rearranging these lands into more manageable and productive holdings to increase the revenues to the beneficiaries.

In 1957, the department was authorized to enter into exchanges to facilitate the marketing of forest products and the acquisition of properties with greater income potential. The legislature instructed the department to enter into exchanges only when in the best interest of the trust for which the land is held and instructed the department not to use exchanges to reduce the publicly owned forest land base.

In 1984, the department's exchange authority was extended to the exchange of trust lands through a land bank. The legislature directed the department to purchase replacement properties that would increase the potential income production of the trust and directed that the use of the land bank not result in the depletion of the publicly owned land base or reduce the publicly owned forest lands.

In 1989, the Trust Land Transfer (TLT) program was created. Under the TLT program, trust lands no longer suitable for trust management are identified and the legislature funds the transfer of these lands to eligible recipients (local jurisdictions, State Parks, DNR's Natural Areas Program, etc.) for recreational use, open space, park, wildlife habitat or natural areas purposes. The value of the timber transferred is deposited in the trust's current account, and the value of the land is used to purchase replacement trust property<sup>2</sup>.

The Trust land transfer process only applies to the Common School Trust as it serves the triple purpose of funding school construction, conserving land and habitat, and diversifying the school trust's portfolio. When another trust's lands are identified as suitable for transfer under the TLT program, the department first does an intergrant exchange between Common School and other trust's lands of equal value if the exchange is in the interest of each trust.

In 1992 the department was authorized to directly transfer trust property to public agencies or to resolve trespass and ownership disputes. The legislature directed that such

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<sup>2</sup> Since 1992 the value of the land has been deposited in the Natural Resources Real Property Replacement Account.

transfer only be made after the property is first appraised, and instructed that properties may not be transferred at less than fair market value, and only transferred if to do so is in the best interest of the affected trust.

As a part of the 1992 legislation, the Natural Resources Real Property Replacement Account (RPRA) was created to receive funds from the transfer of trust lands. Funds placed in the RPRA were to be used solely for the acquisition of replacement property.

### **1.c Activity since 1989:**

From 1989 through the 2002 biennium, more than 84,000 acres have been removed from trust status through the land bank, direct transfer and trust land transfer programs. The transfers (land and timber) were valued at \$420 million. Over \$300 million of the timber value was transferred to the Common School Construction Account through the Trust Land Transfer Program. During this same time period, the department has purchased more than 39,000 acres in replacement property valued at \$127 million. Of this total, about 44 percent of the amount was used to purchase replacement forest land, 54 percent to purchase commercial properties, and the remaining 2 percent to purchase agricultural lands.

### **1.d Return on Investment:**

The weighted average projected total real return on these replacement property acquired since 1989 is 6.7 percent while the nominal return on the permanent fund since 1989 is 6.8 percent. Two adjustments are required before these two returns can be compared.

First, the total real return on the acquisition of replacement property by the department needs to be reduced by the management fund deduction of 25 percent; this results in a net real return to beneficiaries of 5.0 percent.

Second, to make the nominal return to beneficiaries on the permanent fund comparable to the real return on replacement properties, the return on the permanent fund needs to be adjusted for the loss in purchasing power on the permanent fund due to inflation. The loss in purchasing power on the permanent fund since 1989 averaged 3.1 percent per year; this results in an average net real return to beneficiaries on investment in the permanent funds of 3.7 percent.

The projected real return to beneficiaries of 5.0 percent from purchase of replacement trust properties since 1989 is 32 percent greater than the comparable real return to beneficiaries of 3.7 percent from the permanent fund.

**1.e Appreciation and Long-term Revenue:**

One important difference between these two alternative investments is that the beneficiary receives all of the interest income on the permanent fund as it is earned. The real value in purchasing power terms of the corpus of the permanent fund is reduced over time by inflation, while land values increase with inflation. The appreciation in replacement land value accrues to the value of the asset and is realized by the beneficiary through higher rents and/or higher prices for the sale of the assets over time. Thus while the permanent fund may result in a higher dollar return to beneficiaries in the short run, investment in replacement property is expected to result in greater long term revenues to the beneficiaries.

**1.f Diversification:**

Over half of the value of replacement property purchased has been non-forest lands. This diversification of asset value has resulted in the growth of lease revenues from irrigated agriculture and commercial real estate. Revenues from irrigated agriculture leases have increased from \$1.5 million in 1989 to more than \$3.2 million in 2002, a 113 percent increase. Revenue from commercial real estate increased from \$0.9 million in 1989 to \$5.6 million in 2002, a six-fold increase. While irrigated agricultural and commercial real estate holdings represent a small portion of the trusts' land assets portfolio, these data show the positive effect of asset value diversification on sustainable revenue.

**1.g Other Benefits:**

In addition to providing a better return on investment, greater long-term revenue to beneficiaries, and diversification of the trusts asset base, the purchase of replacement property allows the department to meet other legislative objectives given to the department. By purchasing replacement property the department is better able to maintain the publicly owned land base and the publicly owned forest land base.

By purchasing replacement property the department is better able to maintain the sustainable harvest of timber from department-managed lands. Most of the forest lands disposed of through the land bank, direct transfer, and trust land transfer programs were off base or otherwise did not contribute to the sustainable harvest. Timberland acquisitions target stands that increase the sustainable harvest level, thus increasing current revenues to beneficiaries.

By purchasing replacement trust property the department is able to provide multiple use benefits that are consistent with providing revenue to trust beneficiaries. A number of studies have shown that the social, environmental, and economic benefits from trust lands are of great value to the citizens of Washington State. Without the purchase of replacement property these benefits would diminish over time.

### **1.h Recommendations**

This report to the Legislature lays the foundation for on-going discussion about the financial return to the various beneficiaries from the management of the federally granted trusts. The Department has met with or corresponded with representatives of all the beneficiaries in the development of this report. The department is grateful to the many beneficiaries who took the time to read and comment on the draft report.

During the development of this report to the legislature, the department has identified some areas for further study. The following six recommendations incorporate both beneficiaries and the department recommendations.

We recommend that:

- I) Funding be made available to determine the current value of all trust assets managed by the department.
- II) Funding be made available to evaluate the economic, social, and environmental returns to the citizens of the state from the “multiple use” benefits of trust lands that occur collaterally to the returns to the financial beneficiaries.
- III) Based on the results of I and II above, the department together with beneficiaries develop a prudent asset diversification plan for each trust that will increase expected financial returns while reducing risks to beneficiaries.
- IV) The state should evaluate the constitutionally mandated 160 acre parcel size limit for land sales to determine whether this limit or any other acreage limit unnecessarily restricts appropriate diversification of the trust assets; or whether this or other size limit protects the trusts from diminution as a result of large parcel discounts on sales.<sup>3</sup>
- V) The department engage in multiparty facilitated land exchanges, and grouped land transactions to accelerate the rate of diversification and reduce cost where to do so is in the interest of the effected trust(s).
- VI) Funding be made available to investigate a wide array of potential future markets for trust assets that could result in increased revenues to beneficiaries.

The department respectfully submits these recommendations along with this report as requested in the 2002 supplemental capital budget for the legislature’s consideration. We look forward to working with the trust beneficiaries and the legislature on the next steps

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<sup>3</sup> Constitution of the State of Washington - Article XVI, Section 4.

in increasing revenues to the beneficiaries from the trust assets managed by the department.